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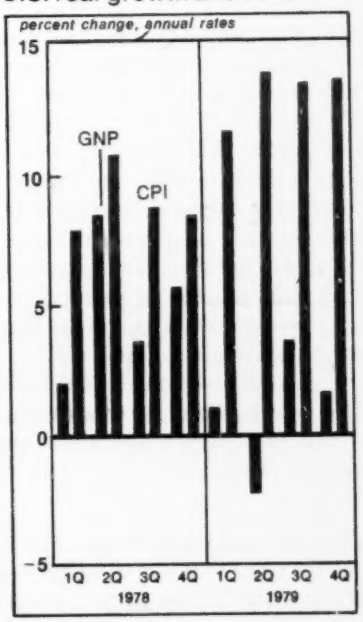
U.S. Economy Resists Recession

It remains to be seen if the long-heralded U.S. recession is yet under way. The evidence is still quite contradictory. Two facts about the U.S. economy do, however, seem clear. First, if it is not declining, it certainly is not growing very fast. Second, the rate of price inflation in the United States remains extremely high by past standards.

There is no doubt about weakness in some important sectors of the U.S. economy. Construction of new housing has been hampered by financing difficulties associated with record-high interest rates. In recent months, new housing units have been started at annual rates 25% below the 2-million level of 1977 and 1978, and further declines are expected. Sales of new automobiles, while highly erratic on a monthly basis, have averaged sharply lower than the 11.2 million units of 1978. Sales of new trucks have fallen even further than auto sales. Some broader economic measures also show weakness. Industrial production, for example, peaked in March 1979, although the decline since then has been modest.

U.S. real growth and inflation



Total activity, however, refuses to decline. Real GNP dropped last spring, but then recovered to show a modest gain of about 1% between the fourth quarters of 1978 and 1979. Employment increased by two million over the year; the unemployment rate was stable until it moved up 0.3 percentage points, to 6.2%, in January. In the face of declines in real income, Americans managed to maintain their level of spending for products other than automobiles last year by reducing their rate of saving. The savings rate has already fallen to record lows for peacetime. Total activity was also bolstered by an increase in capital spending by business and by growth in exports.

Economic activity seems likely to follow a similar pattern in early 1980—up a little here, down a bit there, but not much change overall. Barring shocks such as last year's gasoline shortages, the near-term outlook apparently turns on consumer behavior. For the next several months, at least, consumer prices will continue to rise at rates at least as bad as the 1979 figure of 13.3%. The key question is how long consumer spending can hold up in the face of continued erosion in real income. No other major source of expansionary pressure is on the immediate horizon; the announced increase in military spending programs will have little effect on overall activity until well into 1981. With real consumer spending up again in January, it appears that consumers are not yet ready to pull in their horns. Consequently, the general economic decline may not yet have begun.

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The U.K. monetary outlook.

The U.K. Government has been pursuing a restrictive monetary policy with the understanding that once growth in loan demand moderated, interest rates would be reduced. But the British financial markets were shaken in early February by the announcement that despite record-high interest rates, bank lending was still increasing at a rapid pace. Accordingly, a drop in interest rates now appears less imminent, and most observers see little scope for any change until well after the new budget is introduced in late March. As a result, sterling assets remain attractive to overseas investors, and the pound has been gaining strength—climbing above $2.30 and DM 4.00. The tight monetary policy, however, is also expected to dampen economic growth through 1980 and give the United Kingdom a negative growth rate for the year. This expectation is partly borne out by recent bank lending statistics. The figures reveal a declining proportion of consumer lending and a rising share of lending channeled to industry, indicating less buoyant consumer spending and firms' increased needs to finance unanticipated stockbuilding. As the slowdown gathers momentum, the scope for a cut in interest rates will be increased. Thus, the second half of this year could see a significant easing of credit conditions.

Swiss money policy continues restrictive, but with an eye on the franc.

Swiss monetary policy remains highly restrictive. The narrow money supply (M_1) recorded near-zero growth in the second half of 1979, evidence of the authorities' success in reducing domestic liquidity throughout the year. For 1980, a 4% target growth rate has been set for the monetary base. But since exchange-rate stability remains the key Swiss policy objective, the target may be viewed flexibly. In the short run, high U.S. and German interest rates will keep monetary policy on its present course. However, tight money will produce a lower level of domestic activity in the second half of this year and should help reduce inflation to between 3.5%-4%, as compared with the current rate of more than 5%. Thus, lower interest rates are likely to result around midyear. Since rates are also expected to decline abroad, the downward pressure on rates may be heightened by Swiss actions to prevent an appreciating franc.

Iceland hard put to combat inflation forcefully.

Iceland possesses abundent supplies of cheap geothermal energy, so that the increases in world energy prices have been favorable to the country's energy-intensive aluminum smelting operations and its new ferrosilicone plant. Nonetheless, the impending slowdown in world economic activity is expected to reduce GDP growth to only 1% in 1980 from 2.5% in 1979 and 4.2% in 1978. At the same time, Iceland's balance of payments is likely to shift into deficit after almost two years of surplus. Despite the reasonably strong performance of the real economy, inflation remains high. The rate has risen by about 45% in each of the last two years, and a similar advance is projected for 1980. Successive governments have tried to contain inflation, but the large number of political parties vying for the votes of 220,000 people tends to produce weak coalitions that are unable to implement effective anti-inflationary programs. In the wake of the election of December 1979, it has proven impossible even to form a coalition government. This suggests that the most any new government can do—once it emerges—is to adopt a restrictive monetary and fiscal stance and allow market forces to reduce the upward pressure on wages and prices.

Taiwan's external accounts weak; but foreign investment surges.

The Taiwanese balance-of-payments position deteriorated last year. The trade surplus is estimated to have fallen to $1.3 billion from $2.2 billion in 1978, with the current account shifting into a deficit of about $50 million, after a surplus of $1.7 billion in 1978. Heavy short-term capital outflows contributed to an overall payments deficit of some $250 million. The worsened trade account was the result of a 42% rise in the cost of imports and an increase of only 27% in the value of exports. Oil imports alone totaled about $2.2 billion in 1979, up 37% in cost

and 11% in volume terms above 1978. Expenditures on invisibles also rose sharply. On the brighter side, foreign investment approvals in 1979 set a new record of $329 million, with applications coming from overseas Chinese ($147.4 million), the United States ($80.4 million), and Japan ($50.5 million). The outlook for 1980 calls for continued expansion in the overall payments deficit spurred by high oil prices and expectations of a weak export performance associated with a worldwide growth slowdown. By 1981, however, the external accounts should return to balance, and the longer-run prospects are favorable.

Barbados economy enjoying broad-based growth.

Economic growth in Barbados advanced briskly in 1979. Nominal GDP exceeded $500 million, boosting per capita income to nearly $2,000. A record year for tourism was behind much of the growth, with arrivals up 7% from 1978. Hotels on the island are currently registering occupancy rates of 90%, which has prompted plans to construct 2,000 new hotel rooms. This in turn has placed increasing demands on imported materials and skilled labor. Other sectors of the economy are also performing strongly. A large 125,000-ton sugar crop is anticipated in 1980, and with expectations of higher prices, export earnings should rise substantially this year. The industrial sector is also exhibiting strength, particularly assembly and manufacturing. Thus, the combined momentum of tourism, agriculture, and industry is expected to generate another year of substantial GDP growth in 1980. But price pressures are also building, and the island's inflation rate could very well exceed the 13% rate of 1979.

Saudi current-account surplus expanding sharply.

Saudi Arabia's current-account surplus is estimated to have soared to $16¾ billion in 1979 (on an accrual basis, after official transfers), in contrast with a surplus of about $2 billion in 1978. The sharp rise is attributable to markedly higher net oil export revenues and much slower import growth—which in turn reflects a slowdown in government spending in 1979. The Kingdom's net oil revenue jumped nearly 57% to about $56¾ billion in 1979, a result of the 14.8% increase in petroleum production—which averaged 9.53 million barrels per day—and a 37% rise in contract oil prices. Contract prices (weighted by type of crude exported) rose from an average $12.59 per barrel in 1978 to $17.21 last year. The 1980 Saudi current-account surplus will be sharply higher than in 1979. Even if oil export prices do not rise any further this year (from their current average price of $25.85 per barrel, up 50% from 1978); if 1979 oil output averages 9 million barrels per day; and if imports grow 25% in current dollars; the country's current-account surplus would still nearly double to $32¾ billion in 1980. If oil prices are lifted again this year and/or imports grow at a slower rate (e.g., 20%), the surplus could widen to the $34-$38 billion range.

Tin outlook clouded by international disputes.

After several unsuccessful attempts, the U.S. Congress has finally authorized the domestic sale of 35,000 tons of tin from a total excess of 168,000 tons in the U.S. Government's strategic stockpile. Up to 5,000 tons of this amount will represent the U.S. contribution to the now-depleted buffer stock under the International Tin Agreement (ITA). Domestic sales at a rate of up to 10,000 tons per year could begin some time in March. But there is still considerable doubt about the timing and extent of the sales because of the opposition of tin-producing members of the ITA, led by Bolivia, which has accused the United States of "economic aggression." In view of this uncertainty, and reports that user inventories are low, tin prices have risen to well above levels that would normally have triggered sales from the ITA buffer stock. Nevertheless, supply/demand conditions are currently in approximate balance, with a surplus expected to develop later this year as demand weakens. Prices are thus likely to fall once again, especially if the United States goes ahead with its domestic sales plan.

The New Aggregates and Monetary Policy

The Federal Reserve's recent release of its redefinitions of the monetary aggregates had little impact on most projections of the near-term course of monetary policy. There is, however, much skepticism over whether these new aggregates will significantly enhance the Fed's ability to conduct a more effective monetary policy.

In its release, the Fed announced the creation of five new monetary aggregates:

- M_{1A}, equal to old M_1 (currency plus demand deposits) less demand deposits held by foreign banks and official institutions;
- M_{1B}, equal to M_{1A} plus other "checkable" deposits at all depository institutions, including automatic transfer service (ATS) accounts, negotiable order of withdrawal (NOW) accounts, credit union share drafts, and demand deposits at mutual savings banks;
- *new* M_2, equal to M_{1B} plus savings and small-denomination time deposits at all depository institutions, money market mutual fund shares, overnight repurchase agreements (RPs) at commercial banks, and overnight Eurodollars held by nonbank U.S. residents at Caribbean branches of Federal Reserve member banks;
- *new* M_3, equal to new M_2 plus large-denomination (greater-than-$100,000) deposits at all depository institutions and term RPs at commercial banks and savings and loan associations;
- L, equal to new M_3 plus other liquid assets not included elsewhere, such as term Eurodollars held by nonbank U.S. residents, bankers' acceptances, commercial paper, Treasury bills and other liquid Treasury securities, and savings bonds.

The Fed noted that its action was "prompted by the many financial developments that have altered the meaning and reduced the significance of the old" monetary measures. An important question regarding the new aggregates is thus the extent to which their behavior is "more significant" than that of the old aggregates. This is not easily answered, since there is some controversy over the relevant criteria for a "significant" aggregate.

One criterion often suggested for selecting among alternative measures of monetary aggregates is the relative stability and predictability of the relationship between the demand for each aggregate and the ultimate target(s) of monetary policy, such as GNP. Indeed, one reason why many economists began to question the significance of the old aggregates is that the relationship among these aggregates, GNP, and interest rates has not been very stable during the

Asia and Oceania — Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1979*		BALANCE O				
		3 months ending	change from year earlier	in billions of dollars	per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered	use cre lions
Bangladesh	Despite drought conditions, rice production rose 7% in 1979.	June	+24%	8.9	$ 103	Dec.	386	+ 23%	2.9	
Burma	Japan will lend $100 million for industrialization projects.	Oct.	+81%	4.3	128	Dec.	194	+101%	7.8	
China, People's Republic	Moderate growth of 5%-6% expected to continue in 1980.	June	+40%	$15.0	910	June	3,538	+ 11%	3.0	
Hong Kong	China business and Southeast Asia investor interest will maintain market buoyancy.	Dec.	+37%	11.6	3,320	n.a.	—	—	—	
India	Real GNP in current fiscal year (ending March) estimated to decline 3% or 4%.	Sept.	−18%	122.1	188	Sept.	7,655	+ 24%	11.2	
Indonesia	Oil production fell 5% to 1.55 million barrels per day in 1979.	June	+20%	61.6	413	Dec.	4,062	+ 55%	4.5	
Japan	Real growth in FY 1980 officially forecast to slow to 4.8% from 6.3% in FY 1979.	Oct.	+ 2%	1,078.2	9,310	Dec.	19,522	− 40%	2.1	
Korea	Inflationary pressure continues to build in wake of won devaluation.	Sept.	+24%	64.5	1,697	Oct.	3,073	+ 22%	3.7	
Malaysia	Business confidence apparently unaffected by expectation of U.S. recession.	Aug.	+58%	17.3	1,310	Oct.	3,963	+ 19%	6.6	
Pakistan	Record FY 1978/79 wheat crop boosting agricultural production growth to 6%.	Oct.	+58%	20.9	265	Dec.	213	− 48%	0.6	
Philippines	Government to launch ambitious industrial projects to modernize and diversify economy.	Dec.	+13%	29.1	612	Dec.	2,250	+ 28%	4.8	
Singapore	Year-old property market boom appears to be accelerating further.	Sept.	+47%	8.9	3,708	Sept.	5,694	+ 20%	4.2	
Sri Lanka	Government to receive $10.9 million from Asian Development Bank for rural credit project.	Sept.	+30%	3.1	206	Nov.	461	+ 22%	4.1	
Taiwan	Government increasing incentives for industrial R & D to boost manufacturing value added.	Oct.	+30%	27.6	1,623	Dec.	1,467	+ 4%	1.3	
Thailand	Border troubles and labor unrest undermining business confidence.	Sept.	+27%	26.0	565	Dec.	1,843	− 8%	3.4	
Australia	Business activity remains buoyant; industrial production rises rapidly.	Nov.	+38%	124.0	8,551	Dec.	1,424	− 31%	1.1	
New Zealand	Real GNP growth in fiscal 1980 will decline to 0.5% from 2% in FY 1979.	Oct.	+24%	15.4	4,812	Nov.	603	+ 24%	1.7	
Papua, New Guinea	A $94-million joint U.K. sugar project will begin this year.	Sept.	+44%	0.9**	313	Nov.	571	+ 29%	18.6	

Asia

Oceania

*Preliminary **1978

1970s, especially since mid-1974.

Empirical research by the Federal Reserve Board suggests that the demands for both M_{1A} and M_{1B} have exhibited about the same instability as that for old M_1 during the 1970s, with M_{1B} behaving somewhat more predictably. For the new broader aggregates, however, the same research suggests that the relationships among these aggregates, GNP, and interest rates have been more stable than such relationships using the old broader aggregates. It also appears that new M_2 has been associated with the most stable of such relationships. Moreover, in equations relating GNP growth to money growth, a fiscal variable, and a labor strike variable, new M_2 significantly outperforms all of the old and other new aggregates in terms of the proportion of GNP growth "explained".

Of course, these relationships can only be estimated on a historical basis, and may not hold in the future. As an example, consider the case of M_{1+}, or old M_1 plus savings deposits at commercial banks and other "checkable" deposits at banks and thrifts, introduced in 1978. According to a Fed economist, the demand for M_{1+} appeared to be a relatively stable function of GNP and interest rates until mid-1978. But the relationship fell apart from late-1978 on, and M_{1+} soon fell into oblivion.

A second key criterion for choosing among alternative aggregates is the extent to which the aggregate can be controlled by the Fed. For policy purposes, the significance of the relationship between some aggregate and the ultimate policy targets is limited if the Fed cannot control the aggregate's behavior.

The new redefinitions, however, are not designed to improve the Fed's control over the behavior of the aggregates, but rather to reflect changes in the nature of the public's financial assets. Nothing has been done to strengthen the far-from-perfect relationship between bank reserves and the monetary aggregates.

Furthermore, these monetary redefinitions attempt to deal with the *effect* of financial developments on the behavior of the old aggregates, and not with *causes* of these developments. Specifically, the major catalysts for these developments—deposit interest rate ceilings and punitive reserve requirements on certain categories of bank deposits—remain in effect. Consequently, there is significant potential for further financial innovation that may necessitate future redefinitions of the monetary aggregates.

Thus, while the new aggregates may in some ways be superior to the old aggregates, the old dual problems remain: determining growth rate targets for these aggregates that are consistent with some specific macroeconomic goals; and taking monetary policy actions that assure that these growth targets are attained.

Thomas A. Lawler

PAYMENTS		MONEY AND BANKING							COUNTRIES
		12-month changes				central bank rate	exchange rate in U.S. dollars		
' IMF , mil- dollars	current influences on payments	latest data	consumer prices	latest data	domestic credit	February 13, 1980		current monetary conditions	
27	Trade deficit of $1.4 billion projected for 1979/'80.	Sept.	+17%	Sept.	+ 14%	—	.0675	Tight monetary policy in place to fight inflation.	Bangladesh
71	Oil exports in 1980 projected at one million barrels.	Oct.	+11%	n.a.	—	—	.1575	Relaxed monetary policy continues.	Burma
0	Import growth slowed in second-half 1979.	n.a	—	—	—	—	.7000	Restraint on domestic investment continues.	China, People's Republic
—	Trade deficit in 1980 will be offset by heavy foreign investment.	Oct.	+12%	Nov.	+ 26%	—	.2055	Credit boom continues despite high interest rates.	Hong Kong
0	Trade deficit of $2.5 billion forecast for FY 1980, owing to weak exports.	Oct.	+ 7%	Sept.	+ 19%	9.00%	.1290	Credit conditions restrictive.	India
0	Non-oil exports estimated at nearly $5 billion in 1979.	Oct.	+31%	June	+ 36%	—	.001640	Credit growth remains strong.	Indonesia
0	Oil bill could reach $60 billion in 1980.	Dec.	+ 8%	Oct.	+ 11%	6.25%	.004132	Ceilings on bank lending will continue in 1980.	Japan
8	Oil imports in 1980 estimated at $6 billion.	Dec.	+21%	Oct.	+ 37%	15.00%	.0020	High-interest-rate policy to be maintained.	Korea
0	Oil exports help sustain healthy payments position.	Nov.	+ 4%	Oct.	+ 3%	—	.4605	Government still opposes raising interest rates.	Malaysia
4	Export values jumped 30% in 1979.	Nov.	+ 9%	Sept.	+ 26%	10.00%	.1020	Large budget deficit boosts money supply growth to 15%.	Pakistan
8	High oil-import costs to offset gains in sugar, copra, and copper.	Oct.	+31%	Sept.	+ 24%	4.00%	.1365	Money supply tightened to conform to IMF guidelines.	Philippines
0	Demand for capital-goods imports expected to rise.	Nov.	+ 7%	Sept.	+ 20%	—	.4650	Interest rates climbing as inflation accelerates.	Singapore
9	Recent rise in tea prices will bolster export earnings.	Aug.	+ 6%	Sept.	+ 24%	10.00%	.0675	Tight monetary policy continues.	Sri Lanka
0	Current-account deficit of $1 billion forecast for 1980.	Nov.	+11%	Oct.	+ 18%	14.00%	.0290	Exchange-control liberalization may see temporary halt.	Taiwan
0	Poor sugar crop will hurt export performance this year.	Nov.	+14%	Aug.	+ 33%	12.50%	.0505	Usury law abolished to combat inflation.	Thailand
7	Exports to Japan in 1979 were 29% of total.	Sept.	+ 9%	Sept.	+ 12%	—	1.1070	Reserve Bank raises reserve deposit ratio to 6% from 5.5%.	Australia
6	High wool prices boosted export earnings 20% in 1979.	Sept.	+15%	Sept.	+ 15%	13.00%	.9840	Restrictive monetary policy continues.	New Zealand
3	Higher copper prices bolstered export growth in 1979.	Sept.	+ 5%	Nov.	+ 33%	—	1.47	Credit continues to expand rapidly.	Papua, New Guinea

World Interest Rates

market rates of February 13, 1980; bond yields as of February 8, 1980

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	12.00	14.00	17.00	10.50	9.50	6.00	15.00* penalty rate 18.00	9.50	2.00	6.25
Day-to-Day Money	14.25 Feb. 14	15.00	17.25	12.90	12.125	8.40	16.00*	11.125	0.75	8.25
Treasury Bills 91-day, Middle Rates	12.13	13.50	16.0625	14.40 120-day	n. a.	n. a.	13.712*	no dealing	no market	5.625 2-month
Commercial Paper prime, 3-month, asked	12.50 finance paper	13.95 finance paper 15% tax w/h	15.26	10.40 Certified	12.375 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	13.15	13.95 15% tax w/h	17.00	12.75 Certified	not traded	8.40	18.15*	no market	4.00 not traded	no market
Government Bonds Long-term, new and old issues, average yield	11.57	12.58	13.93	10.99 20% tax w/h	11.73	8.25	14.04*	9.92	4.48	8.11
Industrial Bonds prime, long-term, new and old issues, average yield	12.30 Aa Industrials	13.00	14.29	13.27 20% tax w/h	12.88	8.26	14.42*	10.75	5.46	6.95
Bank Short-Term Rate to Best Borrowers (prime rate)	15.25	15.00	18.00	15.50	13.10	9.75	20.00*	13.50	4.50	6.50
Bank Time Deposits 3-month	13.125 Cert. of Dep.	13.95 Cert. of Dep.	17.375	14.55	12.375	8.65	10.75*	12.00 large deposits	4.9375 residents only	4.00 20% tax w/h
Eurocurrencies 3-month, asked	14.3125	no market	17.4375	no market	12.375	8.5625	no market	12.00	5.125	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.80610	2.3075	.035475	.2458	.5760	.001242	.5227	.6186	.004132
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	1.125 *P*	3.625 *D*	.50 *D*	2.00 *P*	6.00 *P*	4.50 *D*	2.625 *P*	9.50 *P*	5.75 *P*

Eurodollar Deposits
(London, interbank, bid)
February 14

7-day	13.9375
1-month	14.1875
3-month	14.625
6-month	14.6875

International Arbitrage
(3-month, hedged) + *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	− .08
U.S.-Canada Treasury Bills	−1.88
U.S.-Canada Finance Co. Paper	−2.37
Eurodollars-U.K. Local Auth. Deposits	+ .625

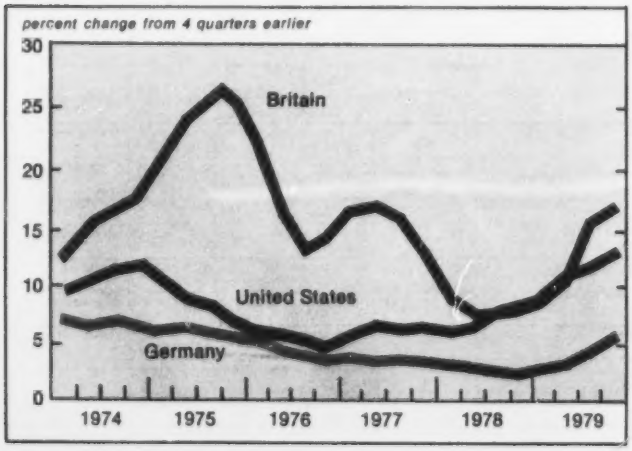
Eurobonds
(average yield on recent straight debt issues)

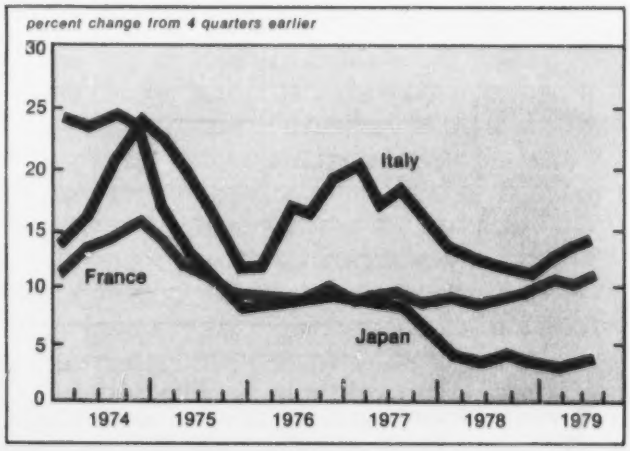
U.S. Dollar Bonds	
7 yrs. and under	12.375
Over 7 yrs.	13.25
DM Bonds	
7 yrs. and under	8.25
Over 7 yrs.	8.25

Gold Price
London afternoon fixing
696.75
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.
* Market rates as of Feb. 6; bond yields as of Feb. 1.

Consumer price trends in major industrial countries





Saudi Arabia Reappraising Priorities

In June of this year, Saudi Arabia's second five-year plan will come to a close. The period—which began with fiscal 1975/76—was marked by a high level of economic activity and inflation, with state outlays totaling approximately $175 billion in current prices, as against the $142 billion in constant dollars originally projected.

The major thrust of the second plan was primarily improvement of infrastructure, but emphasis was also given to expansion of hydrocarbon-based industries and development of the non-oil sector to reduce the country's dependence on petroleum. The plan has apparently achieved most of its objectives. The non-oil sector has expanded very rapidly in recent years. And although real growth in this sector did taper off from its 20% average annual rate during the earlier years of the plan to around 14% more recently, the non-oil sector's contribution to nominal GDP rose from 16% in fiscal 1973/74 to 40% last year. Construction advanced the fastest last year, accounting for 13% of GDP, while agriculture and non-oil manufacturing combined accounted for less than 2%. Thus, the country's petroleum sector continues to predominate. Saudi Arabia remains the world's largest exporter of crude oil, with current output averaging 9.5 million barrels per day. Petroleum earnings are responsible for 60%-70% of nominal GDP, 88%-90% of budget revenues, and nearly 100% of merchandise export earnings.

The Saudi economy grew an estimated 8%-9% in FY 1978/79 (ended in May 1979), spurred by increases in oil production and exports to compensate for reduced Iranian output and a sharp rise in state budget outlays. Real growth in the current fiscal year, however, is expected to fall to the 7% range. This slower growth projection is based on the expectation that oil export growth will weaken in FY 1979/80 in response to the anticipated softening in the world oil market. Furthermore, state budget expenditures this fiscal year are expected to approximate very closely the nominal 8½% increase officially targeted, as compared with the 32% nominal increase in fiscal 1978/79.

Actual state expenditures last fiscal year far exceeded the targeted $39 billion, reaching nearly $44 billion[1]—the first year in which actual expenditures exceeded budgeted amounts since world oil prices accelerated in 1973/74. The high level of expenditures, coupled with a 4% drop in oil revenues and higher imports, gave the Saudis something they were not accustomed to last fiscal year—a $4.3-billion budget deficit. In addition, the current-account balance (on an accrual basis) recorded a reduced surplus of $2 billion in calendar 1978, in contrast to the $23-billion surplus registered in 1974. (Preliminary official estimates indicate that the 1978 current account shifted into a *deficit* of some $57 million on a cash-flow basis.)

The deficit-induced "cash squeeze" forced the authorities to draw down state reserves by an officially reported $1 billion in October 1978 and by another $2 billion in February 1979. As a result, total foreign assets of the Saudi Arabian Monetary Authority (SAMA), the Saudi central bank, declined from $59 billion at the end of 1977 to $55¼ billion as of end-June 1979. In calendar 1979, however, higher oil export volume and prices, combined with slower import growth, raised the current-account surplus (on an accrual basis) to an estimated $16¾ billion; in 1980, the surplus could range anywhere between $32 and $38 billion. (See page 3.) The resulting additions to SAMA's foreign assets thus promise to enhance greatly the country's continued-strong financial posture.

The more restrained budgetary stance for the current fiscal year is partly a response to last year's drop in reserves, but also to fears of resurging inflationary pressure. The implicit non-oil GDP deflator—the most accurate measure of Saudi inflation—has in fact eased sharply from its peak of 52% in fiscal 1975/76 to an estimated 10%-11% in the current fiscal year. The moderation in inflation is a direct result of a broad range of anti-inflationary measures implemented by the authorities since 1977. These include—apart from this year's conservative budget—reducing the growth in the money supply from 54% in 1977 to less than 20% in 1979; acting to alleviate infrastructural bottlenecks; augmenting the supply of housing; revaluing the riyal vis-á-vis the U.S. dollar to curb rises in import costs; and substantially boosting subsidies for basic commodities.

Saudi Arabia's third five-year plan (1980/81-1984/85), to be published by June, will be a particularly revealing document. It will indicate how recent economic and political events have affected the country's longer-term development strategy; e.g., whether future development spending is curtailed or whether development priorities are substantially restructured. The probability is high that greater attention will be paid to improving social services, health delivery systems, education, and manpower training, with more resources allocated to development of non-urban areas and less to ambitious construction projects in major city centers. It is expected that priority will shift from general infrastructural expansion to development of the commodity-producing sectors, especially capital-intensive industry. Spending on national defense, however—which accounts for 33% of expenditures in the 1979/80 budget—will continue to enjoy high priority.

Sharif Ghalib

[1]Excluding independent budgets of autonomous government agencies, which totaled nearly $9 billion.

The EEC Under Stress

The nine-member European Economic Community (EEC) is encountering rough going these days. The latest crises stem from the United Kingdom's objection to its substantial payments into the Community coffer and the Community's inability to reach a consensus as to the 1980 budget.

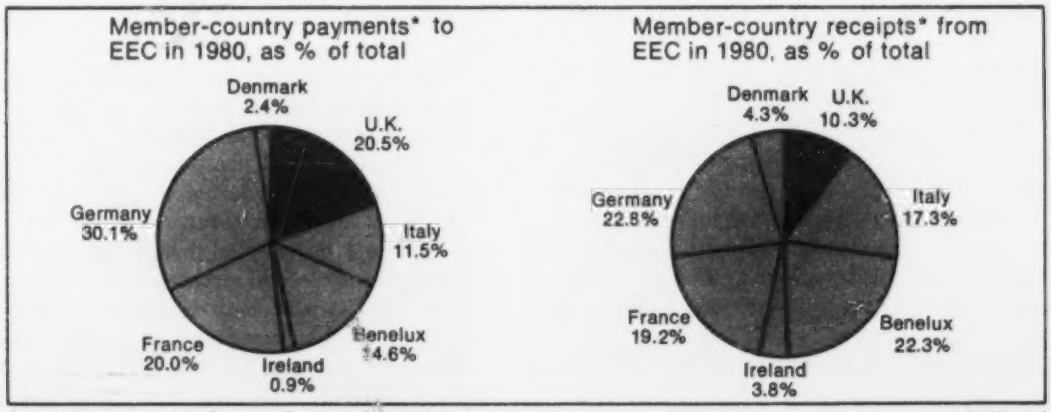
The British are upset about having to contribute an estimated £1 billion more to the EEC than they receive in receipts. The United Kingdom has the seventh lowest per capita GNP in the EEC but makes the largest per capita net payment of any member. This apparent inequity is primarily the result of the funding and disbursement practices of the EEC's Common Agricultural Policy (CAP), which penalizes agricultural-product importers while rewarding agricultural-product producers.

The CAP was designed to guarantee an adequate supply of agricultural commodities to member countries and maintain the income levels of small (and inefficient) farmers. It does this through price supports for EEC-produced agricultural products and by taxing agricultural imports from outside the EEC to maintain a parity with the subsidized EEC prices. The result has been a misallocation of resources, with agricultural supplies well in excess of demand. This in turn has produced large EEC stockpiles of such products as wine, milk, sugar, and butter, which are kept within relatively reasonable bounds only by dumping—i.e., selling at a price below the domestic price—in the world market. The cost of all of this is prohibitively high; indeed, CAP costs currently account for about 75% of total EEC expenditures.

The United Kingdom, which is highly dependent on agricultural imports, is no longer willing to foot the lion's share of the CAP bill without receiving compensating benefits. And since the Community's European Council opposes any actual reduction in U.K. payments, a compromise solution whereby increased EEC expenditures are channeled to the United Kingdom appears most likely. The most talked-about means include increased spending on transportation, infrastructure, and energy development—where U.K. needs are great; low-interest loans; modification of the "financial mechanism" allowing direct cash payments to the United Kingdom; and a tax on non-EEC oil imports to support higher U.K. oil prices. While prospects for a settlement—which would have reduced net U.K. payments by anywhere between £350-£700 million—had been improving, there are new reports of hardened bargaining positions by individual members that promises renewed Community squabbling.

The delay in ratification of the 1980 budget is also CAP-related. The newly elected European Parliament rejected the European Commission's budget proposal last December, with an excessive CAP allocation the main reason. The agricultural ministers of the agricultural-product-producing EEC members were apparently seeking still higher price supports, which would have boosted CAP allocations to a level that threatened to consume the entire Community budget. Accordingly, the agricultural-product-producers—notably France and Germany—must pressure their ministers and farmers to accept reduced price supports if the next budget proposal is to be approved at the Parliament's meeting in late February or March.

The European Parliament's rejection of the 1980 budget has great potential significance for the future of the EEC. The Parliament, which has budgetary authority over policies proposed by the EEC's legislative bodies, has demonstrated a new resolve to wield its (heretofore unexercised) power in the interest of achieving a better balance between agricultural, social, industrial, and energy expenditures. This task will be that much more challenging as the Community expands and its composition changes with the impending membership of Greece, Portugal, Spain, and, possibly, Turkey. The EEC will then have to cope with a more pronounced divergence of national interests and increased demands at the same time that its resources are growing more slowly. *Charles Burd*



Source: Commission of the European Economic Community **estimated*